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No. 76-624

IN THE

Supreme Court of the United States

OCTOBER TERM, 1977

FRANK LYON COMPANY, *Petitioner*,

v.

THE UNITED STATES, *Respondent*.

On a Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

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REPLY BRIEF FOR THE PETITIONER

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The Government contends that tax substance is a legal matter suitable for de novo determination by a court of appeals, yet its brief presents an extended argument based almost exclusively on factual inferences from the evidence. Since the Government has raised so many factual issues, we have found no alternative except to reply to them in detail.

I.

HELVERING v. F. & R. LAZARUS & CO.

The Government rests its case very largely on *Helvering* v. *F. & R. Lazarus & Co.*, 308 U.S. 252 (1939), without recognizing that its argument here is essentially the one which the Court rejected in the *Lazarus* decision. The *Lazarus* case was a two-party case, involving an *owner* and a *finance* agency. The Court held that the finance agency held title simply as security for its loans, and thus had no depreciable interest in the

property. This was directly contrary to the contention of the Government in *Lazarus,* which there contended that "the statutory right to depreciation follows legal title." 308 U.S. at 253.

In the present case, however, there are three parties to the real estate transaction—the *owner* (the petitioner here), the *tenant* (Worthen bank), and the *finance* agencies (First National City Bank, and New York Life). The *Lazarus* decision does hold that the finance agencies are not entitled to deduct depreciation; but it decides nothing whatever as between the *owner* and the *tenant*. Here the petitioner made an investment in the property; it undertook obligations with respect to it. It had a whole congeries of rights in the property, some present and immediate, and others extending over a long period of years, and dependant on events as they might occur in the future.

That the petitioner financed part of its permanent investment through loans from New York Life, and that it expected to be able to repay these loans from rents to be paid by the tenant, is hardly relevant. That is true with respect to the owner-investor in almost every large real estate construction transaction. The *owner* does not have all the money required, so he borrows some or all of it from a *finance* agency on the security of the structure; and then, in order to repay his loan he enters into a lease with a *tenant*, expecting that the rentals will meet his loan obligations. The fact that he borrows, or that he rents, does not make the owner any less an owner entitled to deduct depreciation and interest, though he necessarily gives up a considerable portion of his "bundle of interests" to the finance agency and to the tenant. The fact that the rent money is used to pay off the financing obligation does not make the owner a "conduit". (Govt. Br. 53.) See *Commissioner* v. *Brown,* 380 U.S. 563 (1965). Where the owner makes his own investment in the property, assumes and meets the finance obligations, and has substantial, though uncertain, interests in the future, he is the owner of the property, entitled to depreciation, and nothing decided in *Lazarus* indicates the contrary.

The Government continues to slight the issues which *Lazarus* identified as central to the right to take depreciation—the intent of the parties, the burden of depreciation and obsolesence of the asset, and the findings of the trier of fact.

A. Even where lip service is given to the burden of depreciation (a 2-page treatment begins at page 56 of the Government's 71-page brief), the conclusion reached is that Worthen "will enjoy the *benefits* of the building over its entire economic life." (Govt. Br. 57; emphasis supplied.) This not only misstates the situation substantially, it focuses on the wrong issues—the benefits to Worthen and the asserted "ceiling" on Lyon's return. This sort of reasoning is relied on again and again. Govt. Br. 26, 31, 38, 41, 57, 62. But as the court admonished in *Estate of Franklin* v. *Commissioner,* 544 F.2d 1045, 1049 (9th Cir. 1976):

> Bad bargains from the buyer's point of view—as well as sensible bargains from buyer's, but exceptionally good from the seller's point of view—do not thereby cease to be sales. *See Commissioner* v. *Brown,* 380 U.S. 563 (1965); *Union Bank* v. *United States,* 285 F.2d 126, 128, 152 Ct.Cl. 126 (1961).

From the viewpoint of the purpose of the depreciation deduction, this insistence on Worthen's benefits actually undermines the Government's position. It is Worthen rather than Lyon which is largely insulated

from risks occasioned by diminution in value; and it is Worthen therefore which is in a position similar to the banks whose ownership was disregarded for tax purposes in the cases relied on by the Government—*Union Planters National Bank of Memphis* v. *United States*, 426 F.2d 115, 117-118 (6th Cir. 1970), cert. denied, 400 U.S. 827, and *American National Bank of Austin* v. *United States*, 421 F.2d 442 (5th Cir. 1970), cert. denied, 400 U.S. 819. Worthen will never be obliged to pay more than fair rentals, and it has available an option price which the Government contends is low.[1] Lyon can of course insist upon Worthen's upkeep obligations (which exclude reasonable wear and tear), but these conditions are an ordinary aspect of the net lease.

B. Seemingly, the Government relies on Worthen's benefits because these are clearer in the documents on which the Government totally depends. The risks of the transaction and the frangibility of the asset will only be made certain by the course of events, and such factors do not fit well into the Government's rigid conceptual universe of common law ownership, and factual predictions presented as legal conclusions.

This Court took a very different approach to determining "tax substance" in the *Lazarus* case, upon

[1] In its statement of the question presented, Govt. Br. 2 (and throughout its brief), the Government erroneously asserts that the lessee had an option to acquire title to the building "for an amount that was unrelated to its fair market value." This statement is in flat contradiction with the findings of the district court and the facts of record. Though computed in terms of a 6% compounded return on $500,000 plus the assumption of the unpaid balance of the New York Life mortgage, this was the parties' attempt to arrive at a fair market value of the property and is a method commonly used in sale and leaseback transactions (I App. at 127, 228, 234, 240-241).

which the Government relies so heavily. Instead of dogmatically asserting what the facts were, as the Government does here, the *Lazarus* Court assessed the situation as it presented itself to the parties in order to determine the substance of the transaction.

The Board of Tax Appeals and the Court of Appeals for the Sixth Circuit had held that the deed to the bank, though absolute in form, was in reality intended by the parties as a mortgage to secure a loan. Both the taxpayer and the bank testified that they intended the transaction as a long-term loan secured by the real estate. The taxpayer further testified that it was not interested in selling its property, that it would not have sold for $3,250,000 property worth $6,000,000, and that the annual rentals established to service the loans were less than the fair rental value of the property. This Court said, 308 U.S. at 254-55 (emphasis added):

> "... The Board in substantial effect found that the instrument under which the taxpayer purported to convey legal ownership to the trustee bank *was in reality given and accepted* as no more than security for a loan on the property; the 'rent' stipulated in the concurrently executed ninety-nine year 'lease' back *was intended* as a promise to pay an agreed five percent interest on the loan; and the 'depreciation fund' required by the 'lease' *was intended* as an amortization fund, designed to pay off the loan in forty-eight and one-half years. *These findings are supported by evidence* which permits, at most, conflicting inferences *and are*, therefore, *conclusive here*. And, unless the Board committed error of law we must affirm."

C. In the present case the evidence indicates and the trier of fact found that option prices and rentals were reasonable estimates of market values, that the trans-

action was a bona fide sale and so intended by the parties, and that risks of depreciation are borne by Lyon—both in the decreasing option prices and rentals as the building ages, and the risk that the building will depreciate in value below the option prices and rentals. The situation is fundamentally different from that presented in *Lazarus* since the question here is not between the owner and the finance agency, but is between the owner and the tenant, and the findings of the trier of facts which this Court said in *Lazarus* are "conclusive here" clearly support the taxpayer. Thus *Lazarus* supports Lyon, not the Government.

II.

THE GOVERNMENT'S ARGUMENT THAT THIS CASE PROPERLY PRESENTS ONLY QUESTIONS OF THE CONSTRUCTION OF WRITTEN INSTRUMENTS IS UNSOUND

Although the Government says that its conclusions in this matter are based solely on interpretation of the documents and legal conclusions drawn therefrom, every crucial point of its argument depends on factual predictions and judgments. The Government asserts that the option prices were "nominal" and that there is no "realistic way" in which Lyon can benefit from the arrangement. Govt. Br. 29. Various factual contentions raised by the Petitioner are said to be "highly unlikely" or "highly improbable". *Id.* at 31, 34, and 38. It attempts to evade the findings of the district court on the issue of the relationship between options or renewal rentals and fair market value by saying that there was no evidence on this point (*id.* at 45), when in fact it seeks to controvert the evidence offered by the parties, and by the independent realty consultant, and accepted by the district court.

Even aside from the fact that there is no way that these assertions could have been drawn from interpretation of the documents, they are effectively undercut by three points.

1. The Government never introduced any evidence whatever on fair and reasonable market and rental values. The petitioner did produce such evidence and the district court credited it fully. What the Government now argues is either that the district court made some factual misinterpretation of the record or that rentals are never fair if they equal amortization expenses plus an agreed return on equity. See n. 1, *supra*.

2. While presenting its predictions and real estate assessments as inevitable legal conclusions drawn from the documents, the Government fails to point out the fact that its predictions and assessments have changed continuously in its attempt to fit the transaction into the neat categories provided by the traditional common law. At trial the Government focused on the low initial ground rents (now conceded to be a wash), and the asserted inevitability of the exercise of the eleventh year option because that was the period when the tax benefit would be greatest (an event now conceded to be unlikely). Between the court of appeals and this Court, the Government has abandoned two factors which were persuasive to the court of appeals: allocation of the investment credit to Worthen (a tax benefit which is by statute freely allocable between the parties, I.R.C. § 48(d)); and the assertion that Lyon could not sell the building to third parties. (There is no prohibition of Lyon's selling the building and Lyon has had opportunities to sell at a profit, which it has declined in order to hold on to the investment. I App. 261-62; P. Ex. 51, II App. 687.)

Moreover, the Government has added a new point which it totally ignored below, allegedly "bargain" renewal rentals. According to the opinion of the district court below, the Government did not even contest the matter of reasonableness of the renewal rents, Pet. App. 6a, though it has now been translated—without benefit of evidentiary support or prior consideration—into the decisive factor. See Section IV, A, *infra*.[2]

[2] On pp. 19-20 of its brief, the Government states that the Court of Appeals' decision was based on six findings of fact, and in its subsequent arguments the Government relies heavily upon these "facts". Examination of the facts reveals that the Court of Appeals was in error in each of these "findings" on which its opinion was based.

(1) The lease agreement "circumscribed petitioner's right to profit from its investment in the building" by giving Worthen the options to purchase for $500,000 plus 6% compounded interest and the assumption of the unpaid balance of the New York Life mortgage. This is untrue for the following reasons: (a) Frank Lyon Company had the right, and many opportunities, to sell the building at a greater profit at any time (I App. 261-62; II App. 687, P. Ex. 51); (b) the 6% return compounded annually cannot be said as a matter of law to be too insubstantial to be attractive to a true investor in real estate; (c) the 6% return compounded annually was the *minimum* return petitioner would realize if Worthen exercised one of its options (I App. 162-63), an event the district court found to be highly unlikely; and (d) petitioner would own the building and realize a much greater return than 6% if Worthen did not exercise an option to purchase (I App. 34-36, 50-53). See pp. 16, 23, *infra*.

(2) "[T]he option prices did not take into account possible appreciation of the value of the building or inflation." Govt. Br. 20. To the contrary, the district court found the option prices to be the negotiated estimate of the parties of the fair market value of the building on the option dates and to be reasonable (I App. 303). Such estimates would necessarily have considered appreciation and inflation as well as depreciation and obsolescence; the Court of Appeals seems to have confused the value of the land, which is not likely to depreciate, with the value of the building, which is. See Pet. Br. at 26-34.

(3) "[A]ny award realized as a result of the destruction or condemnation of the building in excess of the mortgage balance and petitioner's $500,000 investment would be paid to Worthen and not petitioner." Govt. Br. 20. This was true only with respect to *total* destruction or taking of the building *after December 1, 1980*. Petitioner, not Worthen, would receive the excess above the mortgage balance in the event of *total* destruction or taking *before December 1, 1980* or in the event of *partial* damage or taking *at any time* (I App. 408-10; 411).

(4) While it is true that "the building rental payments during the 25-year primary term were exactly equal to the mortgage payments", Govt. Br. 20, this does not justify the conclusion that "petitioner merely served as a conduit by which the mortgage payments would be transmitted to New York Life." Govt. Br. 20. This ignores the fact that petitioner was the sole obligor on the New York Life note and would remain liable in the event of default by Worthen. The fact that the rent was sufficient to amortize the loan during the primary term of the lease was a requirement of New York Life, and is a usual requirement in most long-term loans secured by a long-term lease (Pet. App. 12a). The absence of a pretax cash flow is not unusual in many real estate investments (I App. 235). Testimony proved and the district court found that the rents during the primary term were reasonable and represented the fair rental value of the building, a fact not contested by the Government. (I App. 236, Pet. App. 6a).

(5) Worthen did not "retain control over the ultimate disposition of the building through its various options to repurchase and to renew the lease plus its ownership of the underlying land." Govt. Br. 20. The Court of Appeals here ignored (a) petitioner's right to sell the building to another investor at any time; (b) the lower court's finding that the options to purchase would not likely be exercised, (c) the uncertainty that Worthen would renew the lease for 40 years, see pp. 22-23, *infra*, (d) petitioner's right to lease to anyone at any price during the last 10 years of the ground lease, and (e) petitioner's continuing ownership of the building after the expiration of the ground lease, see pp. 15-16, *infra*.

(6) "Worthen enjoyed all of the benefits and bore all the burdens incident to the operation and ownership of the building so that the only economic advantage accruing to petitioner . . . were income tax savings of $1.5 million during the first 11 years of the arrange-

3. The cases on which the Government relies are inadequate to support its position here. In the cases dealing with bond transactions between banks and dealers,

the "objective economic substance" of the transactions could be readily determined from their short duration, the limited range of possible outcomes, and the fact that the results which occurred fell into a repeated and predictable pattern. *American National Bank of Austin* v. *United States,* 421 F.2d 442 (5th Cir. 1970), cert. denied, 400 U.S. 819; *Union Planters National Bank of Memphis* v. *United States,* 426 F.2d 115, 117-18 (6th Cir. 1970), cert. denied, 400 U.S. 827. Not only were the terms of the arrangement undisputed, the factual results were as well. The banks were protected from any loss whatever, and there was never any refusal to resell to the dealers in the history of the arrangements. It was the dealer who bore the risk of market fluctuations. See 426 F.2d at 118.

In the present case, by contrast, the practical results of the carefully planned arrangement into which Lyon and Worthen have entered depends on a number of future events, including future market values, the future situation of the parties, and the future of the banking business and the real estate market in Little Rock. As even the Government states in a veiled concession, "petitioner did not . . . stand to suffer from any decrease in [the building's] value (unless the value fell below the option price) . . ." (Govt. Br. 23.) As Lyon has indicated in its brief, pages 26-34, and *infra* at pages 22-

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ment." Govt. Br. 20. As the district court found, the benefits of occupancy which Worthen will enjoy are quite common in most long-term real estate leases (I App. 309-10). The district court also found that petitioner had motives other than tax-savings in entering into the transaction, i.e., a need to diversify its holdings, a need to use its accumulated earnings, and the long-term return it could expect when the mortgage indebtedness was retired (I App. 298, 308-09). Finally, the net cash after-tax benefit would be $312,220, not $1.5 million. (I App. 273, D; Ex. 6 at II App. 696).

23, this concession understates the risk to Lyon. But this qualification on the Government's present factual position, along with its vacillation on the prospects of the arrangement, makes it clear that factual inferences and predictions in the instant transaction present considerable elements of doubt and risk. Compare also *Estate of Franklin* v. *Commissioner,* 544 F.2d 1045, 1049 (9th Cir. 1976).

The crucial questions here are questions of factual inference and prediction, and it is determination of these questions which is necessary to arrive at the "substance" of the transaction. The Government badly misrepresents the findings and holding of the district court below when it indicates that its holding was based entirely on a finding of subjective intent or deference to "labels". Govt. Br. 25. The court upheld the contentions of the taxpayer based upon findings as to "'objective'" as well as "'subjective'" intent, and upon the conclusion that "the transaction was in substance, as well as form, a sale-leaseback with option to repurchase" and not a mere financing or tax avoidance scheme. Pet. App. 2a.

III.

THERE IS NO BASIS IN THE RECORD OR PRECEDENT FOR TREATMENT OF THE TRANSACTION AS A SHAM, OR OF LYON AS AN ACCOMMODATION PARTY.

A. The Government has never denied the separate existence and motives of the parties, has never disputed directly the existence of substantial nontax motives, and has never maintained that relations, or some sort of side agreement between the parties, would indicate that this transaction was in any way a sham or not bona fide.

The Government now, however, produces the contention that the bargaining was not "arms-length" in nature because the parties are to be mutually advantaged by the transaction and a part of the advantage relates to tax treatment. Govt. Br. 62-65. In *Holbrook* v. *Commissioner*, 450 F.2d 134 (5th Cir. 1971), cited in Govt. Br. 36, the Fifth Circuit effectively rejected the sort of reasoning the Government has used here (450 F.2d at 142-53):

> "Surely it cannot be inferred solely from the fact that a tax advantage will be reaped from it that the subrogation right was given for tax reasons only and was without substance. Without proof that the debtor in such cases was controlled by the taxpayer, or in some other condition or circumstance indicating a lack of substance to the taxpayer's right of subrogation, we do not think the Tax Court is as liberty to so find. Credit purchases and the granting of subrogation rights, like sales, are commonplace in our economic system. They are so ordinary that we are not willing to presume them to be shams or lacking in economic reality without affirmative proof. We instead presume ordinary contract rights to have value in the absence of contrary proof."

"Adverseness" or arms-length bargaining need not be based on total hostility. It was the clear import of the holding of the court below (Pet. App. 2a, 6a, 11a), and the testimony of the parties as well as the representative of New York Life, that the bargaining was thorough and strenuous:

> "Well there was just considerable give and take, bargaining, negotiating among the parties. I assume these documents are in evidence. There were volumes of documents and were negotiated chapter and verse, paragraph by paragraph, almost word for word." I App. 85-86. (Testimony of New York Life representative).

The cases which the Government cites for its characterization of Lyon as an "accommodation party" in the arrangement illustrate the bankruptcy of the Government's position on this point. Govt. Br. 55, and n. 37, citing *Nelson* v. *Commissioner*, 281 F.2d 1 (5th Cir. 1960); *United States Fidelity & Guaranty Co.* v. *Commissioner*, 40 B.T.A. 1010 (1939). First, both cases involved determination of tax consequences as between a wholly-owned subsidiary and its parent or owner. The relationship is in no way comparable to that presented here. Second, in treating the wholly-owned subsidiary as a conduit, the *Fidelity & Guaranty* court made it clear that there was no conceivable way in which the "accommodation party," the subsidiary, could profit from the transaction. Even the Government concedes some nontax benefits will accrue to the Lyon Corporation. Third, the *Nelson* court ultimately denied the taxpayer's attempt to ignore the corporate entity of its subsidiary because it found that the corporation had an independent existence and was not a sham entity. 281 F.2d at 6. There is, of course, even more basis in this instance to recognize and affirm the distinction between the entities and interests in this case. See also *Holbrook* v. *Commissioner, supra.*[3]

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[3] In consenting to petitioner's assignment of the building lease to New York Life, Worthen did agree to pay the rent directly to New York Life. Govt. Br. 35-36. However, this provision, for the protection of New York Life in the event of a default by petitioner in the payment of its note to New York Life, has never been required by New York Life. Worthen has in fact paid its rent *monthly* to petitioner, which rent has been deposited in petitioner's regular checking account. Petitioner has in turn met the *quarterly* payments on its note to New York Life by sending New York Life a check drawn on petitioner's bank account (I App. 77-78).

B. The Government cites the fact that Lyon accepted Worthen's proposal without trying to get any more favorable terms. Govt. Br. 62-63. But (1) Lyon thought it had to lower its bid to get the building because of the other investors (I App. 112-13; Pet. App. 10a); (2) Mr. Barnes and Mr. Lyon testified that the building could easily be sold under the lease to a third party (I App. 242, 261-62); and (3) Lyon was only accepting the broad proposal, it could and did attempt to get more in actual negotiation.

The conclusion that Worthen dictated all the terms or that Lyon retained no interest is simply untenable. *See, e.g.*, I App. 31, 32, 46, 86. The Government states "that Worthen's president testified that petitioner had 'nothing whatsoever to do' with determining the substantive provisions of the contract." Govt. Br. 62. This quotation is lifted from context in a misleading way. Edward Penick testified that the "format of a sale-leaseback" transaction was dictated by the bank regulatory authorities prior to petitioner's interest in the transaction, so that petitioner had "nothing whatsoever to do" with the "form of the arrangement" (I App. 155), not, as the Government loosely asserts, "the substantive provisions of the contract."

The basic terms, rather than being "dictated by Worthen", were the result of proposals by potential investors, including petitioner, in a highly competitive situation. Rather than share the investment with Stephens, Inc. as suggested by Worthen and anxious to be the low bidder, petitioner submitted a counterproposal reducing the rent $21,000 per year for the first five years (I App. 25, 27-28).

After petitioner had been selected by Worthen as the owner, based upon petitioner's low bid on the above

basic terms of the transaction, petitioner negotiated with Worthen, New York Life and First National City Bank in hard arms-length bargaining for six months over innumerable terms of the various agreements (I App. 29, 39, 85, 86, 150). It was during this period, for example, that petitioner bargained for and obtained from Worthen an extension of the ground lease for a period of 10 years beyond the building lease at a rental of only $10,000 per year (I App. 35-37), and bargained for and obtained Worthen's various indemnity and hold harmless clauses to protect petitioner against losses (I App. 95-105).

C. In attempting to negate any feature of the transaction which is inconsistent with its picture of Lyon as a straw man, the Government is driven to inconsistent and confusing statements about two of the most obvious aspects of Lyon's ownership of the building: its unencumbered ownership of the building after the end of the lease with the concomitant rights during (1) the last ten years of the ground lease, and (2) the period after the end of the ground lease.

The principal confusion stems from the contention that Lyon will have no rights whatever in the building once the term of the ground lease is up. The Government's contention seems to be that Lyon cannot maintain that it has rights as the owner of the building under Arkansas law if Lyon is not the owner of the building for Federal tax purposes. Govt. Br. 42, n. 27. This is an obvious non sequitur.

The district court held that Lyon was the owner of the building under Arkansas law (I App. 291; Pet. App. 3a) and the Government has not contested that conclusion prior to this point. Petitioner's brief sets

forth at length the understanding and agreements of the parties on ownership and points out the specific omission of any right of reversion in Worthen. Pet. Br. 41-44. Even if it were to be concluded that Lyon is not the owner for Federal tax purposes, this should not change the property rights of the parties inter sese. As the reasoning of the court in *Union Planters National Bank of Memphis* v. *United States*, 426 F.2d 115, 117 (6th Cir. 1970; McCree, J.), cert. denied, 400 U.S. 827, indicated, even if the intent of the parties is not controlling for Federal tax characterization purposes, it is still crucial to their rights inter sese. The Government has not advanced any reason why Federal tax law should control rights between the parties, or consequences under Arkansas property law.

The Government also argues that "equity" would preclude Lyon from receiving any equitable adjustment for the building because the parties agreed that Lyon's return was to be six percent, and an adjustment might raise its overall return above this figure. Govt. Br. 41-42, n. 27. This is a clear example of result-oriented thinking on the part of the Government. It has extrapolated the six percent figure from its calculations based on the rentals and options, but there is no indication whatever in the agreements between the parties or elsewhere in the evidence that the resulting number has independent significance as a ceiling upon any return by Lyon, however achieved. On the contrary, the record indicates that Lyon relied on and bargained for the rights in question, see, e.g., I App. 35-37, and has always expected greater return than six percent. See n. 2, *supra*.

D. The Government shows, in successive footnotes, a similar confusion on the period between the end of

the building lease and the end of the ground lease. Govt. Br. 39-40, nn. 25 and 26. On the one hand, Lyon's right to the use of the building during that period is crucial to the Government theory of a flat six percent return. It is during this final period, the Government maintains, that Lyon is able to make up the difference between the rental provided for in the lease agreement and the amount necessary to bring its return of the $500,000 equity investment up to six percent. *Id.* at n. 26.[4] On the other hand, the Government sees the obvious danger to its "conduit" construction in Lyon's free rights to use the building for ten years. Accordingly, the government implies that the building is likely to be completely depreciated in value by that time, in effect, that all return in that period is hypothetical and irrelevant to the nature of the transaction. *Id.* at n. 25. This line of argument, of course, flatly contradicts the notions that the rental paid during the renewal terms were bargain rentals, and that return during the ten year period following the expiration of the building lease was an important part of the understanding; the Government cannot have it both ways.[5]

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[4] The Government has adopted this reconciliation of the ten-year period from the opinion of the Court of Appeals. Pet. App. 19a.

[5] The Government also errs in asserting that "the ground lease would terminate *if Worthen did not renew the building lease* or if it exercised its option to purchase the building (P. Ex. 18, Sec. 9, II-A, II App. 369)." Govt. Br. 13, n. 12; emphasis added. The cited section 9 of the Ground Lease provides that the ground lease will terminate only upon termination of the Building Lease pursuant to Worthen's purchase of the building in the event of damage or destruction (Article XVII), condemnation (Article XVIII) or exercise of options to purchase at the end of the 11th, 15th, 20th or 25th year of the lease (Article XX).

IV.

THE GOVERNMENT'S UNSUPPORTED FACTUAL ASSERTIONS ABOUT OPTION PRICES AND RENTALS ARE CONTRADICTED BY THE RECORD, THE DISTRICT COURT DECISION, AND THE PRECEDENT UPON WHICH THE GOVERNMENT RELIES.

A. At this advanced stage of the litigation, the Government has come up with yet another formulation of the "substance" of this transaction with which it attempts to rationalize the Court of Appeals' decision. The Government again asserts that its position is purely legal and derived from interpretation of the documents, though it depends on unsupported assertions about what is "likely" to happen to the building, to the parties, and to values, and about the relationship between market values and option prices and rentals.[6]

The newest formulation of the transaction designed to cast Worthen as the tax owner focuses on the renewal rentals to be paid after the initial term of the lease has ended. Govt. Br. 44-52. Since these are supposedly "bargain" or "nominal" rentals, the indication is that Worthen has purchased an equity in the building through its payments during the initial term.

[6] The Government has also introduced for consideration FASB Statement of Financial Accounting Standards No. 13, Accounting For Leases (November 1976). Govt. Br. 49-52. By its own terms, however, this statement does not have any relationship to the issue of tax treatment; the Board rejected tax treatment as a guide, ¶ 71, and conformity of tax and accounting treatment as a consideration, ¶ 78. Under FASB 13, there are instances in which a lease would be a "capital lease" ("This is not to say, however, that such transactions are necessarily 'in substance purchases' as that term is used in previous authoritative [accounting] literature." Id. at ¶ 60), but would still qualify for an advance ruling as a bona fide lease for tax purposes under *Rev. Proc.* 75-21. Compare Section 4(1)(C) of *Rev. Proc.* 75-21 with paragraph 7(c) of FASB 13.

The Government relies on characterizations of these rents as "favorable" and "very cheap" made by the independent realty witness and the president of Worthen Bank respectively. Id. at 46. The Government asserts that the district court failed to make a finding on the crucial issue of the relationship between renewal rentals and fair market price, and that the bargain rentals undermine any contention that Worthen is not the real owner of the building.

The findings of reasonableness made by the district court relate to the rentals over the entire period.

> The evidence reflected, and the Court finds, that the rent to be paid by Worthen during the term of the lease is reasonable, *a fact not contested by defendant.*" Pet. App. 6a (emphasis added).

Evidence of all the rental terms was before the district court, including evidence which indicated that the decreasing rentals were related to the decreasing value of the building.[7] The difference between rentals for the primary term and those thereafter reflects a burden of depreciation borne by Lyon, rather than "equity" built up by Worthen. Brief of Petitioner at 28-34.[8]

[7] The renewal rentals were the result of competitive bidding between potential investors (I App. 77) and were considered by petitioner "to be fair and equitable in relation to the value of the building at that point" (I App. 27).

[8] *Midler Court Realty, Inc.* v. *Commissioner*, 521 F.2d 767 (3rd Cir. 1975) is cited by the Government, Br. at 49, for the proposition that unreasonably low renewal rentals deprive the lessor of ownership rights. The issue, however, in the *Midler* case was whether there was a premium included in the initial rent terms which were much higher than renewal rents. The *Midler* court rejected such reasoning based merely on a disparity; it concluded that the rents in both instances reflected fair market values and relied upon the fact that the transaction was arms-length. Disparity can be ex-

B. Both the factual and the legal basis for the Government's arguments that the renewals make Worthen the "owner" are extremely scanty.

The Government did not present any evidence below concerning the relationship between the lease rental and market values, although it now identifies this relationship as crucial under the precedents. Govt. Br. 42.[9] If, as the court indicated in *Estate of Franklin* v. *Commissioner*, 544 F.2d 1045, 1049 (9th Cir. 1976), cited in Govt. Br. 67, the crucial failure is the failure to show any relationship between the option prices and fair market value, then that failure is the failure of the Government and the court of appeals below rather than of the taxpayer as in the *Franklin* case.

Examination of the cases on which the Government relies in contending that Worthen is the owner because of bargain renewal rentals reveals a very different factual pattern from that presented here. Govt. Br. 49. The Government contends that the rents there and here are "nominal" but neglects to attach any specific meaning to that term. The principal cases relied upon,

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plained by other circumstances, there, 521 F.2d at 773, as here. See pp. 22-23, *infra*.

[9] The initial theory which underlay the determination of deficiency was totally different. The Government had calculated that Lyon's tax benefit would be greatest if the option was exercised at the end of the eleventh year. The Government assumed in calculating tax liability that this would be the case and argued the inevitability of this result at trial. See I App. 285-86, 293-94. Dispute centered on the reasonableness of the option and the likelihood of exercise of the options. Now that the Government has evolved a new theory, these factors are irrelevant. Although both theories rest upon the relationship between prices set in the contracts and fair market values, the Government never introduced any evidence whatever relating to either theory.

Starr's Estate v. *Commissioner*, 274 F.2d 294 (9th Cir. 1959), and *Mt. Mansfield Television, Inc.* v. *United States*, 239 F. Supp. 539 (D.Vt. 1964), affirmed, 342 F.2d 994 (2nd Cir. 1965), cert. denied, 382 U. S. 818, present a very different understanding of "nominal". In both of those cases the reduction in rent from the primary to the renewal term was over 90%. Moreover, in both of those cases the "lessor" had recovered his investment and an agreed percentage return by the end of the initial rental term.[10] Nominal rentals combined with prior recovery of investment indicated that the "lessor's" interest in the property was for all practical purposes limited entirely to the primary lease term, where recovery of investment and agreed return was achieved.

The situation is entirely different here because (1) the renewal period rentals are quite substantial—the net rental in the initial renewal term is $200,000 per annum or $1,000,000 over the 5 year period which is totally net to Lyon, and (2) Lyon will not achieve its "agreed return" of six percent unless the option is exercised or until after the time the building reverts to Lyon's use at the end of 65 years. Govt. Br. 40, n. 26. It is undeniable that Lyon has a continuing interest because, even in the Government's formulation, Lyon must depend upon the condition and use of the building free of the lease—the residual value of the building—in order to achieve its return.

C. Moreover, the Government attempts to indicate that the testimony of the independent realty consultant

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[10] See also *Frenzel* v. *Commissioner*, 1963 P-H Memo TC, ¶ 63, 276 (October 7, 1963) cited in the Brief of the Solicitor General at 49. The Government also cited *Midler Court Realty*, 521 F.2d 767, discussed at n. 8, supra.

—that the option prices were reasonable—was based on the artificially low renewal rents. But this assertion is refuted by consideration of the record; the Government has apparently confused testimony concerning two separate topics. Govt. Br. 45, citing I App. 241, 251. At I App. 241, Mr. Barnes was asked if the option prices were reasonable approximations of the fair market value of the building at the future dates in question, and whether the method of fixing option prices which was used was both common and reasonable. His reply to both questions was unhesitatingly affirmative. This line of questioning was conducted with reference to the value of the building as it presented itself to the parties at the time of negotiating the option prices, that is, without consideration of the value of the lease itself.

The later discussion, I App. 251, was quite different. The question was not the reasonableness of the option price, but whether Worthen was likely to exercise the option. The expert's opinion was that Worthen was not likely to do so because the rental terms were "favorable," or in other words that the present value of rentals over the extended term was less than the amount necessary to exercise the option.

D. The focus on the relationship between renewal rentals and fair market rental values is not entirely consistent with the Court of Appeals' decision which the Government is attempting to support. In identifying the factors which supposedly had the "cumulative effect" of depriving Lyon of a depreciable interest in the building, the court did not stress the factors now identified—the relation between market prices and rentals and option prices—as crucial at all. The Court of Appeals made no findings whatever concerning market value—which the Government nonetheless identifies as crucial—because to do so it would have had to overrule as clearly erroneous specific findings of the district court on the reasonable relationship between market values and options and rentals.

E. Finally, one of the most critical aspects of the "market value" question which the Government has consistently failed to recognize is that the value of the building—at the end of the 25-year term or at any time—may be different to Lyon, Worthen, and to various third parties depending on their circumstances. Having been rebuffed in its arguments that the level of the options first at 11 and then at 25 years economically compelled Worthen to exercise them, the Government now argues that the question of exercise of the option is "irrelevant". Govt. Br. 47. The theory is that bargain renewals allow Worthen to sublet the building at a profit whether it uses it or not. Govt. Br. 48. This suggestion, while ingenious, has never been brought forward before, and it has several flaws.

The renewal rentals are supposed to be a "bargain" but at the moment there is no indication of how much of a bargain the merchandise might be at that point. If the building had depreciated substantially, capital investment might well be necessary, and the profitability of a sublease would depend on the amount of investment necessary, the availability of capital, the return on alternate investments, the expense and difficulty of managing the building, and so forth. All of these issues are problematical at this point and the Government has certainly failed to present any substantial support for its particular hypothesis. The only two things which are clearly shown on the record are (1) the continuing capital problems of Worthen, and (2) the diminishing utility and repair of the building over time.

The contradictions and inconsistencies of the Government's position are understandable in light of the fact that the theory had to be built at such an advanced stage of the proceedings, and the Government could not rely upon any attempt below to lay factual foundation or explore the inconsistencies with precedent. Nonetheless, there is no more basis for accepting this formulation of the transaction than any of the others through which the Government has sifted in the attempt to justify its result.

V.

CONCLUSION

In sum the Government has failed to reconcile either the approach or the result of the court of appeals below with sound tax administration, the realities of the transaction, the precedent on which it relies, or the Government's own various formulations of the case. If the approach pressed by the Government is followed, it will mean that no question in this area can be settled until the final appellate court has spoken. Yet taxpayers must plan, and the Internal Revenue Service should be in a position to apply the law in at least a roughly predictable fashion. The Government gives no weight

to these objectives at any point in its brief."[11] Principled and orderly administration of the tax laws requires that the decision of the court of appeals be reversed, and the district court's decision allowing the deduction of depreciation and interest by the petitioner be affirmed.

Respectfully submitted,

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[11] It is startling that the Government argues that advance rulings and advice of counsel can dispel the uncertainty brought about by the holding below. Govt. Br. 59, n. 41. When citing Revenue Procedure 75-21, which the IRS has offered as guidance, the Government neglects to mention that this *Rev. Proc.* met with strong protest from the real estate industry, and that the IRS indicated that it would not be generally applied to real property, but that "some if not many of the ruling guidelines should be applicable." See Rosenberg and Weinstein, "Sale-Lease-backs: An Analysis of these Transactions after the Lyon Decision," 45 Journal of Taxation 146, 147 n. 1 (1976) (the authors characterize both the *Lyon* court and the IRS as "groping for guidelines").

In the instant litigation, the petitioner would have been unable to predict the position of the Government from one stage of the proceeding to the next. Advice of counsel, which petitioner of course sought, received, and followed, hardly solves these problems.